BILL ANALYSIS

Department, Board, Or Commission	Author	Bill Number
Franchise Tax Board	**Senate Comm. On Budget & Fiscal Review**	**SB 86**

SUBJECT

FTB Revise Tax Form Instructions To Include Use Tax Lookup Table/ Eliminate Refundable Portion Of Child & Dependent Care Expense Credit /Financial Institution Record Match/ Voluntary Compliance Initiative

SUMMARY

This bill would do the following:

Provision No. 1: Require the Franchise Tax Board (FTB) to revise the income tax forms and instructions to include a use tax table that would allow taxpayers to determine the amount of use tax they owe.

Provision No. 2: Revise the current child and dependent care expenses tax credit to be nonrefundable.

Provision No. 3: Authorize a voluntary compliance initiative (VCI) permitting taxpayers to file amended returns and pay the tax and interest associated with abusive tax avoidance transactions (ATATs) or unreported offshore income and avoid criminal prosecution and the imposition of certain penalties;

Make amendments to current law to encourage participation in the VCI; and

Make amendments to eliminate definitional inconsistencies in current abusive-tax-shelter laws by creating a uniform definition of an ATAT.

Provision No. 4: Establish a record match process between financial institution customer records and FTB debtor records. FTB would use the match information, which would be more current than information now available to FTB, to collect delinquent state income tax debts and non tax debts using existing laws and computer systems.

PURPOSE OF BILL

According to the text of the bill, the purpose of this bill is to address the fiscal emergency declared by the Governor by proclamation on January 20, 2011.

EFFECTIVE/OPERATIVE DATE

As an act that provides for an appropriation and that has been identified as related to the budget in the Budget Bill, this bill would become effective immediately upon enactment. The operative dates of these provisions vary and are addressed separately for each provision.

ECONOMIC IMPACT – SUMMARY REVENUE TABLE ($ in Millions)

Fiscal Year ($ in millions) Enactment Assumed by May 1, 2011	**10/11**	**11/12**	**12/13**	**1314**
Provision No. 1: Require the FTB to revise the income tax instruction to include a use tax table that would allow taxpayers to determine the amount of use tax they owe.	*	*	*	*
Provision No. 2: Revise the current child and dependent care expenses tax credit to be nonrefundable.		+$100**	+$100**	+$100**
Provision No. 3: VCI and related amendments.	+$270	-$48	-$29	-$5
Provision No. 4: Financial Institution Records Match (FIRM).		+$37	+$30	+$32
TOTAL	**+$270**	**+$89**	**+$101**	**+$127**

* Provision No. 1 would not impact state **income tax** revenues. No estimate is provided by FTB of the impact to state **use tax** revenues.

** Provision No. 2 is based on current law. If the Governor's budget proposals that would extend the ¼ percent personal income tax rate and continue the reduction of the dependent exemption credit are enacted, the revenue for this provision would be reduced to gains of $70 million instead of $100 million.

PROVISION NO. 1: Use Tax Table

OPERATIVE DATE

This provision would be specifically operative for purchases of tangible personal property made on or after January 1, 2011, in taxable years beginning on or after January 1, 2011.

ANALYSIS

STATE LAW

The Board of Equalization (BOE) is responsible for collecting sales and use tax. California use tax is imposed on any person who purchases tangible personal property for use, consumption, or storage in this state where the purchase is not subject to California sales tax. Generally, use tax is owed when the purchase is made outside of California, but the property is used in California. A typical purchase subject to California use tax is a purchase shipped from an out-of-state retailer to a California consumer. The state use tax rate is the same as the sales tax rate, which varies between 8.25 percent and 10.25 percent until July 1, 2011, when the rates will vary between 7.25 percent and 8.75 percent depending on the county and city within California. Taxpayers may report and pay state use tax directly to BOE or they have the option of reporting and paying use tax on their California income tax return.

THIS PROVISION

This provision would allow a person that on or after January 1, 2011, has made one or more single non-business purchases of individual items of tangible personal property, each with a sales price of less than $1,000, to report the use tax liability by using a use tax table shown in the instructions for the individual tax return or by reporting the actual use tax due. In addition, this provision would preclude the BOE from making any determinations for understatements of use tax against any person with qualified purchases who utilizes the use tax table in accordance with the accompanying instructions.

This provision would require the FTB to revise the income tax booklet instructions to include a use tax table that would allow taxpayers to determine the amount of use tax they owe. The BOE would be required to provide the use tax table to the FTB by July 30, of each calendar year.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

SB 858 (Committee of Budget and Fiscal Review, Stats. 2010, Ch. 721) among other items reauthorized and made permanent the option for taxpayers to report use tax on their personal income or corporation tax returns.

AB 469 (Eng, 2009/2010) would have replaced the option for a taxpayer to report use tax on the state income tax return with a requirement to report use tax. This bill was vetoed October 11, 2009, by Governor Schwarzenegger, stating that AB 469 exposes individual taxpayers to additional recordkeeping and confusion about a tax that few Californians understand and even fewer track for tax purposes.

AB 2676 (MA, 2009/2010) would have made permanent the law allowing taxpayers the option to file and pay use tax on their income tax returns in addition to expanding collection authority by the BOE. This bill was vetoed September 29, 2010, by Governor Schwarzenegger, stating that the significant provisions of AB 2676 have already been addressed by the Budget Conference Committee.

AB 969 (Eng, 2007/2008) was the same as AB 469 (Eng, 2009/2010). This bill was vetoed October 14, 2007, by Governor Schwarzenegger, stating concerns that the effective date for AB 969 would be too soon for taxpayers to compile records of their purchases that would be subject to the use tax for calendar year 2007.

SB 1009 (Alpert, Stats 2003, Ch. 718) added the election for taxpayers to report and pay use tax on their state personal income tax returns.

OTHER STATES' INFORMATION

The states surveyed include *Florida, New York, Illinois, Massachusetts, Michigan, and Minnesota.* These states were selected due to their population and similarities to California's economy, business entity types, and tax laws.

Florida does not impose a personal income tax.

New York, *Illinois, Massachusetts,* and *Michigan*, allow individuals to utilize a use tax table to pay use tax on the personal income tax return.

Minnesota does not allow individuals to report use tax on the personal income tax return.

FISCAL IMPACT

Implementing this provision would not significantly impact the department.

ECONOMIC IMPACT

This provision would not impact state **income tax** revenues.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

PROVISION NO. 2: Child and Dependent Care Expenses Tax Credit

OPERATIVE DATE

This provision would be specifically operative for taxable years beginning on or after January 1, 2011.

ANALYSIS

FEDERAL/STATE LAW

Current federal and state laws allow a credit for expenses that taxpayers incur for qualified child or dependent care expenses necessary so that they may engage in gainful employment or pursuit of gainful employment. For federal purposes, this credit is nonrefundable; for state purposes, it is refundable.

THIS PROVISION

This provision would make the credit for child and dependent care expenses nonrefundable for taxable years beginning on or after January 1, 2011.

IMPLEMENTATION CONSIDERATIONS

Implementing this provision would require some changes to existing tax instructions and information systems, which could be accomplished during the normal annual update.

LEGISLATIVE HISTORY

SB 1366 (Kuehl, 2001/2002) would have made technical, non-substantive changes to the child and dependent expense credit, but was held in the Senate Rules Committee.

AB 847 (LaSuer, 2001/2002) would have increased the state adjusted gross income amounts used to determine the percentage of child and dependent expense credit available, removed the language that allowed the credit to be refundable, and allowed the credit to be carried over indefinitely. AB 847 failed to pass out of the first house by the constitutional deadline.

AB 480 (Ducheny, Stats. 2000, Ch. 114) created the California Child and Dependent Care Expense Credit.

OTHER STATES' INFORMATION

The states surveyed include *Florida, New York, Illinois, Massachusetts, Michigan, and Minnesota.* These states were selected due to their location and similarities to California's economy, business entity types, and tax laws.

Florida does not impose a personal income tax.

New York offers a refundable child and dependent care expense credit.

Illinois, Massachusetts, and *Michigan* do not offer a child and dependent care expense credit.

Minnesota offers a nonrefundable child and dependent care credit.

FISCAL IMPACT

This provision would require the existing form for the child and dependent care expense credit to be modified in addition to some system programming changes. These changes could be incorporated into the department's annual update, and as such, the costs would be minor.

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of Provision to
Repeal Refundable Portion of the Child & Dependent Care Expenses Credit
For Taxable Years Beginning On or After January 1, 2011
Enactment Assumed by May 1, 2011
($ in Millions)

	2011-12	2012-13	2013-14
Current Law	+$100	+$100	+$100
Governor's Budget Proposals	+$70	+$70	+$70

Interaction of this provision with the extension of the 1/4 percent personal income tax rate and the continuation of the reduction of the dependent exemption credit in the Governor's budget proposals would reduce the revenue that would result from this change. For that reason, the table above provides the revenue impact under current law and if the 1/4 percent rate extension and the continuation of the reduction of the dependent exemption credit are enacted. This estimate does not account for changes in employment, personal income, or gross state product that could result from this provision.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

PROVISION NO. 3: VCI Two

OPERATIVE DATES

The operative dates of the VCI Two provisions would be as follows:

- The VCI Two filing period would be operative from August 1, 2011, to October 31, 2011.
- Amendments to the interest-suspension rules would be operative for notices mailed or amended returns filed on or after January 1, 2012.
- Amendments to the accuracy-related penalty would be operative for notices mailed on or after January 1, 2012.
- Amendments to the FTB's subpoena authority would be operative for subpoenas issued on or after the bill's effective date.
- Amendments to the noneconomic substance transaction understatement penalty would be operative for notices mailed on or after the bill's effective date.
- Amendments to the extended statute of limitations would be operative for taxable years that have not been closed by a statute of limitations as of August 1, 2011.
- Amendments to the interest-based penalty and the uniform definition of an ATAT would be operative for notices mailed on or after the bill's effective date, and to amended returns filed more than 90 days after the bill's effective date.

BACKGROUND

Abusive Tax Shelters

Abusive tax shelters are tax schemes that serve no significant purpose other than reducing tax. The IRS, the FTB, and the courts generally deny claimed tax benefits if the transaction that gives rise to those benefits lacks significant economic substance independent of income tax considerations, even though such transaction may not literally break any tax law.

In the late 1990s, the number and complexity of abusive tax shelters grew exponentially. Abusive tax shelters were structured with multiple transactions, multiple taxpayers, or both, in order to complicate the issue and impede detection. To combat this problem, and to restore fairness to the tax system, California and the federal government have enacted legislation to combat abusive tax shelters.

In 2000, Congress created interlocking disclosure obligations for both taxpayers and advisors requiring both to disclose (i.e. "report") in writing to the IRS potentially abusive transactions, known as "reportable transactions."[1] To enforce these disclosure obligations, Congress subsequently enacted strict-liability penalties that apply to both taxpayers and advisors for any failure to disclose a reportable transaction.[2] California generally conforms to the federal reportable-transaction disclosure requirements and penalties, with modifications.[3]

In 2003, California enacted the first-in-the-nation comprehensive state-level anti-abusive-tax-shelter statutes that codified the term ATAT, created a regime of penalties and other provisions to curtail the use of ATATs, and enacted a VCI that permitted taxpayers to file amended returns, pay the tax and interest associated with an ATAT, and avoid criminal prosecution and the imposition of certain penalties.[4]

While state and federal legislation enacted in the 2000's was generally effective in curtailing the use of that era's mass-marketed abusive tax schemes, ATATs continue to be a problem for both the FTB and the IRS, as ATAT promoters continue to concoct more sophisticated and customized abusive tax schemes.

For example, the FTB recently became aware of an abusive tax scheme where corporations use one or more partnerships to improperly reduce the amount of their California income; thus, on January 6, 2011, the FTB "listed"[5] this scheme as an ATAT, requiring all parties involved to file disclosure statements, imposing penalties for any failure to adequately disclose the ATAT, and subjecting understatements resulting from such schemes to additional penalties.

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[1] The IRS issued temporary reportable-transaction regulations on February 28, 2000, and those regulations became final on February 28, 2003. Treas. Reg. section 1.6011-4.

[2] Subtitle B of Title VIII of the American Jobs Creation Act of 2004 and Section 2041 of the Small Business Jobs Act of 2010. The strict-liability penalty for the failure to disclose a reportable transaction is generally 75 percent of the reduction in tax reported on the participant's income tax return as a result of participation in the transaction, or that would result if the transaction were respected for federal tax purposes; however, the minimum penalty is $5,000 and the maximum penalty is $200,000. IRC section 6707A.

[3] R&TC sections 18407 and 19772. The California penalty only applies to taxpayers with taxable income of more than $200,000, and the penalty for failure to disclose a reportable transaction (other than a listed transaction) is $15,000, and the penalty for failure to disclose a listed transaction is $30,000.

[4] The VCI filing period was from January 1, 2004, to April 15, 2004, collecting approximately $1.3 billion in revenue from 1,138 taxpayers.

[5] FTB Notice 2011-01, *Abusive Tax Shelters – California Listed Transactions – Abusive Sales Factor Manipulation*, see http://www.ftb.ca.gov/law/notices/2011/2011_01.pdf

Additionally, the Tax Division of the U.S. Department of Justice recently announced that its civil priorities for 2011 include the abuse of corporate and individual tax shelters (which are estimated to cost Treasury at least $10 billion annually), schemes, scams, and offshore tax evaders. Tax Division attorneys will continue to participate with other federal agencies in investigating and prosecuting corporate executives, either from a straight tax fraud angle or a corporate angle, and federal prosecutors will continue to pursue international tax crime, including the use of secret offshore trusts in foreign bank accounts to evade taxes.[6]

Offshore Tax Evasion

Offshore financial arrangements designed to evade tax generally involve tax-haven countries that offer financial secrecy laws in an effort to attract investment from outside its borders. In addition, numerous schemes have been uncovered in which the true ownership of offshore income streams and offshore assets have been hidden or disguised. As a result, substantial amounts of financial activity and its associated income have been improperly shielded from federal and state income taxes.

Over the last few years, the federal government has significantly stepped up its efforts to combat offshore tax evasion. In February, 2009, Swiss bank UBS entered into a deferred prosecution agreement under which the bank admitted to helping U.S. taxpayers hide accounts from the IRS. UBS bankers routinely traveled to the U.S. to market Swiss bank secrecy to U.S. clients interested in attempting to evade federal and state income taxes. Court documents assert that, in 2004 alone, Swiss bankers allegedly traveled to the U.S. approximately 3,800 times to discuss their clients' Swiss bank accounts. As part of a deferred prosecution agreement, UBS provided the U.S. government with the identities of, and account information for, certain U.S. customers of UBS's cross-border business.

Hoping to get taxpayers with unreported offshore income back into the U.S. tax system, the IRS developed a voluntary disclosure initiative that ran from March, 2009, to October, 2009. This initiative offered taxpayers an accuracy-related penalty (ARP) of up to 20 percent in lieu of other applicable penalties and possible criminal prosecution if taxpayers disclosed offshore activity and paid any tax and interest attributable to such activity. Approximately 15,000 voluntary disclosures from individuals were received. Since then, the IRS has received an additional 3,000 voluntary disclosures from individuals with bank accounts from around the world.[7] A second offshore voluntary disclosure initiative was announced by the IRS on February 8, 2011. This initiative allows taxpayers to participate until August 31, 2011, and is similar to 2009 initiative, except that it offers an ARP of up to 25 percent in lieu of other applicable penalties and possible criminal prosecution if taxpayers disclose offshore activity and pay any tax and interest attributable to such activity.

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[6] *DOJ Official Outlines Civil, Criminal Enforcement Priorities for 2011*, Stephanie Berrong, Tax Analysts, Tax Notes Today, JANUARY 25, 2011.

[7] IRS Commissioner Doug Shulman's Statement on UBS / Voluntary Disclosure Program, see http://www.irs.gov/newsroom/article/0,,id=231520,00.html

From the information received from its first initiative, the IRS has identified several more banks and promoters involved in offshore tax evasion. IRS Criminal Investigation division deputy chief Rick Raven recently said that the IRS is "enjoying unprecedented cooperation with other countries," stressing that offshore compliance "is not just a Swiss issue," and said information has come in that involves numerous countries and scores of banks.[8] And, on February 23, 2011, the U.S. Justice Department obtained indictments for four individuals, alleging that these individuals facilitated offshore tax evasion for U.S. taxpayers by opening undeclared accounts–to the tune of $3 billion in assets–and submitting false qualified intermediary agreement forms to the IRS.[9]

ANALYSIS

FEDERAL/STATE LAW

Federal Law

In General

The Internal Revenue Code (IRC) provides detailed rules specifying the computation of taxable income, including the amount, timing, source, and character of items of income, gain, loss, and deduction. These rules permit both the taxpayers and the government to compute taxable income with reasonable accuracy and predictability. Taxpayers may generally plan their transactions in reliance on these rules to determine the federal income tax consequences arising from the transactions.

A tax shelter is a tax scheme that has as its significant purpose the avoidance or evasion of tax.[10] Tax shelters are generally structured with one or more of the following characteristics:

- Little or no motive of realization of economic gain;
- Intentional mismatching of income and deductions;
- Overvalued assets or assets with values subject to substantial uncertainty;

[8] *Past Lessons Guiding New IRS Offshore Disclosure Initiative*, *CI Official Says*, Jeremiah Coder, Tax Analysts, Tax Notes Today, February 18, 2011.

[9] The indictment alleges that the defendants and their co-conspirators caused U.S. customers to travel outside the U.S., to destinations including Switzerland and the Bahamas, to conduct banking related to their secret accounts; opened secret accounts in the names of nominee tax haven entities for U.S. customers; accepted IRS forms that falsely stated under penalties of perjury that the owners of the secret accounts were not subject to U.S. taxation; advised U.S. customers to structure withdrawals from their secret accounts in amounts less than $10,000 in an attempt to conceal the secret account and the transactions from American authorities; and, advised U.S. customers to utilize offshore credit, and debit cards linked to their secret accounts and provided the customers with such cards, including cards issued by American Express, Visa and Maestro.

[10] IRC section 6662(d)(2)(C)(ii).

- Non-recourse financing and financing techniques that do not conform to standard commercial business practices; and
- Mischaracterization of the substance of the transaction.

Certain tax-shelter transactions are set up with an incidental business purpose to make them appear to be non-shelter transactions; however, a transaction is still a tax shelter if, after being stripped of its tax benefits, it has an insignificant amount of economic value when compared to its tax benefits.

General Tax-Shelter Penalties

Federal tax-shelter penalties include: (1) imposition of a 20-percent accuracy-related penalty (ARP) (20 percent of the amount of tax underpaid due to the tax shelter) without relief from the substantial-authority and adequate-disclosure exceptions;[11] (2) a separate ARP of up to 30 percent on understatements that result from reportable transactions;[12] and, (3) a separate ARP of up to 40 percent on underpayments that result from transactions lacking economic substance.[13]
Penalty Coordination

Federal law provides coordination among the above-listed penalties to provide that any understatement is only subject to one of the penalties (i.e., the general ARP, the separate ARP on certain reportable transactions, or the separate ARP on noneconomic substance transactions).

[11] IRC section 6662. The 20-percent accuracy-related penalty generally applies to the portion of any underpayment that is attributable to (1) negligence, (2) any substantial understatement of income tax, (3) any substantial valuation misstatement, (4) any substantial overstatement of pension liabilities, (5) any substantial estate or gift tax valuation understatement, (6) any transaction that lacks economic substance, or (7) any undisclosed foreign financial asset understatement. Except in the case of tax shelters, the amount of any understatement is reduced by any portion attributable to an item if (1) the treatment of the item is supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed and there was a reasonable basis for its tax treatment.

[12] IRC section 6662A. A reportable transaction is generally any transaction that has a potential for avoiding or evading tax and the transaction is required to be included on a return or statement. The separate accuracy-related penalty applies to understatements resulting from reportable transactions if a significant purpose of such transaction is the avoidance or evasion of federal income tax. The penalty is 20 percent of the understatement if the transaction is adequately disclosed and 30 percent of the understatement if it is not, and the adequate-disclosure and reasonable-cause exceptions do not apply.

[13] IRC section 6662(b)(6). The separate accuracy-related penalty applies to an underpayment attributable to any disallowance of claimed tax benefits by reason of a transaction lacking economic substance, as defined in IRC section 7701(o), or failing to meet the requirements of any similar rule of law. The penalty rate is 20 percent, increased to 40 percent if the transaction is not adequately disclosed.

Additionally, federal law denies interest suspension for ATATs. Interest suspension is the term used to describe the suspension of the imposition of any interest, penalty, or addition to tax if the IRS does not issue a notice of additional proposed tax within 36 months from the date of a timely-filed return. Interest, penalties, or additions to tax may not be computed on the additional proposed tax from the day after that 36-month period until 21 days after the notice is issued. Interest suspension does not apply to any undisclosed transaction that the IRS has determined to have the potential for tax avoidance or evasion or to any transaction that the IRS has determined to be an ATAT.[14]

State Law

In General

California generally conforms to the federal rules specifying the computation of taxable income, with modifications, and conforms to federal definition of a tax shelter.

General Tax-Shelter Penalties

California generally conforms to the federal tax-shelter penalties that: (1) impose the 20-percent ARP without relief from the substantial-authority and adequate-disclosure exceptions,[15] and (2) impose a separate ARP on understatements that result from reportable transactions.[16] California does not conform to the separate ARP on underpayments that result from transactions lacking economic substance, but instead has its own noneconomic substance transaction understatement (NEST) penalty.

The California NEST penalty is imposed on any noneconomic substance transaction understatement.[17] A "noneconomic substance transaction understatement" is an understatement resulting from the disallowance of any loss, deduction or credit, or addition to income that is attributable to a transaction that lacks economic substance. A transaction is treated as lacking economic substance if the taxpayer lacks a valid nontax California business purpose for entering into the transaction. The NEST penalty is 20 percent of the understatement if the transaction is adequately disclosed and 40 percent of the understatement if it is not. Reasonable-cause and adequate-disclosure exceptions do not apply, and the penalty may only be relieved by the Chief Counsel of the FTB.

[14] IRC section 6404(g).

[15] R&TC section 19164.

[16] R&TC section 19164.5.

[17] R&TC section 19774.

Penalty Coordination

California law provides coordination among the above-listed penalties to provide that any understatement is only subject to one of the penalties (i.e., the general ARP, the separate ARP on certain reportable transactions, or the NEST penalty).

Other Provisions

Other California tax-shelter provisions include the denial of interest suspension, an interest-based penalty, an eight-year statute of limitations, and authorization for the Executive Officer of the FTB to sign certain subpoenas.

Interest suspension generally applies in a similar manner as it applies under federal law. If the FTB does not issue a notice of proposed additional tax within 36 months from the date of a timely-filed return, interest, penalties, or additions to tax may not be computed on the additional proposed tax from the day after that 36-month period until 15 days after FTB issues that notice. Additionally, interest suspension does not apply to taxpayers with taxable income greater than $200,000 that have been contacted by the FTB regarding a potentially abusive tax shelter.[18]

If a taxpayer has a deficiency that results from the use of an undisclosed reportable transaction, a listed transaction, or a gross misstatement, a penalty based on interest applies. The penalty is 100 percent of the interest payable up to the date that a notice of proposed deficiency is mailed. Because the penalty is based on the amount of interest on a deficiency, a taxpayer may avoid the penalty by filing an amended return prior to the FTB issuing a deficiency notice.[19]

If the FTB identifies an adjustment relating to an ATAT, the FTB may notify the taxpayer of a proposed deficiency assessment up to eight years after the taxpayer has filed the return, rather than the normal four-year statute of limitations.[20]

The FTB may issue a subpoena to any person to carry out its duty of administering the franchise and income tax laws. Generally, a subpoena must be signed by a member of the FTB; however, in the case of a potentially abusive tax shelter, the Executive Officer of the FTB or any designee is authorized to sign a subpoena.[21]

[18] R&TC section 19116.

[19] R&TC section 19777.

[20] R&TC section 19755.

[21] R&TC section 19504.

THIS PROVISION

This provision would authorize the FTB to administer a VCI (herein "VCI Two") that would provide a narrow tax amnesty for taxpayers that utilized an ATAT or that have unreported income from the use of an offshore financial arrangement, and would make amendments to current law to encourage participation in VCI Two.

The primary terms of VCI Two would be as follows:

- The filing period would be August 1, 2011, to October 31, 2011.
- VCI Two would apply to taxable years beginning before January 1, 2011.
- Participants would be required to file amended returns and pay all unpaid tax and interest resulting from an ATAT or from unreported offshore financial arrangements, and all VCI Two issues would be closed without appeal rights.
- Taxpayers eligible to participate in VCI Two would include taxpayers that have:
    - ATATs currently under audit;
    - ATAT cases in protest;
    - Unknown ATATs; and
    - Unreported income from the use of an offshore financial arrangement.
- For qualified participants, all penalties would be waived except for the:
    - Large corporate understatement penalty (LCUP); and,
    - Amnesty penalty.
- No criminal action would be brought against any qualified VCI Two participant that, as of July 31, 2011, is not the subject of a criminal complaint or under criminal investigation in connection with an ATAT or unreported income from the use of an offshore financial arrangement.
- The statute of limitations for the FTB to find and issue an assessment on ATAT cases would be increased from eight to twelve years.
- The interest-based penalty would be modified to prevent taxpayers from avoiding the penalty by filing an amended return after being contacted by the FTB, but prior to the FTB issuing a deficiency notice; instead, 50 percent of the penalty would be imposed on any such amended return filed after the VCI Two filing period.
- The current-law California NEST penalty would be modified to provide that it would be imposed on any California understatement resulting from a transaction that the IRS examines and determines lacks economic substance.

Additionally, this provision would eliminate the current-law inconsistencies of the definition of abusive tax shelters by creating a uniform definition of an ATAT, which would mean any of the following:

1. A California tax shelter;
2. A reportable transaction that's not adequately disclosed;
3. A listed transaction;
4. A gross misstatement; or
5. A transaction subject to the NEST penalty.

This provision would coordinate this uniform definition of ATATs in the application of:

- The interest-based penalty;
- The interest-suspension rule;
- The twelve-year statute of limitations; and
- The authority to issue subpoenas.

LEGISLATIVE HISTORY

SB 342 (Wolk, 2010/2011) would enact a VCI similar to this bill, except that it would also include enacting a new reportable transaction category for transactions of interest and would conform to the federal 20-percent penalty on baseless refund claims. That bill is currently in the Senate Committee on Government and Finance.

AB 2498 (Skinner, 2009/2010) would have enacted a VCI that would have been similar to this bill. That bill was not brought for a vote in the policy committee of the second house.

AB 115 (Stats. 2005, Ch. 691) modified the ATAT statutes to conform to certain provisions of federal abusive-tax-shelter legislation that was enacted in 2004.

SB 614 (Cedillo and Burton, Stats. 2003, Ch. 656) and AB 1601 (Frommer, Stats. 2003 Ch. 654) required the FTB to promote and administer a VCI and enacted a regime of penalties and other provisions to curtail the use of ATATs.

FISCAL IMPACT

FTB staff estimates costs of approximately $631,000, $513,000, and $509,000 for fiscal years 2010/11, 2011/12, and 2012/13, respectively, for additional personnel, processing, and system-change costs to implement the VCI Two provisions of this bill.

ECONOMIC IMPACT

Estimated Revenue Impact of VCI 2 Enactment Assumed By May 1, 2011 ($ in Millions)			
2010-11	2011-12	2012-13	2013-14
+$270	-$48	-$29	-$5

This estimate does not account for changes in employment, personal income, or gross state product that could result from this provision.

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

PROVISION NO. 4: Financial Institution Records Match (FIRM)

OPERATIVE DATE

This provision would be specifically operative 120 days after the effective date. Additionally, the first data exchange for purposes of matching tax debtor records to financial institution account holder records would occur no earlier than April 1, 2012.

ANALYSIS

FEDERAL/STATE LAW

Current federal law mandates the Financial Institution Data Match (FIDM) for the collection of delinquent child support debts. This process involves the matching of child support obligors with financial institution customer records in order to identify and levy the funds belonging to the obligors. Federal law prohibits the information received through FIDM to be used for any purpose other than child support collection.

Under federal and state law, every individual, partnership, limited liability company, bank, corporation, estate, trust, or other organization engaged in a trade or business is required to file information returns to report various types of non-payroll compensation and other miscellaneous income. The types of transactions reported on the information return include, among other things, payments of interest, dividends, and certain gambling winnings. The filing requirements and dollar reporting thresholds vary and are generally contingent on the reporting requirements for the state in which the Form 1099 recipient resides.

The California Right to Financial Privacy Act (the Act) prohibits financial institutions from disclosing confidential account records, unless certain exceptions are met. Criminal search warrants and subpoenas are two examples of exceptions. Current law provides that the Act supersedes any law that appears to violate the provisions of the Act, unless that other law specifically provides that the Act does not apply to that particular law.

Current state law authorizes FTB to use several collection tools in order to collect delinquent tax liabilities, one of which is an Order to Withhold (OTW). An OTW can be issued to any third person in possession of funds or properties belonging to a tax debtor. Upon receipt of an OTW, the recipient notified is required to freeze the tax debtor's assets in their possession and hold those assets for ten days, and then remit to the department all cash or cash equivalents held that will satisfy the amount of the OTW. If the recipient of the OTW is in possession of any assets other than cash or cash equivalents, they must hold that item, notify FTB, and await further instructions.

Current law prohibits FTB from disclosing any confidential taxpayer information unless specifically authorized by law.

THIS PROVISION

This provision would require FTB to coordinate with financial institutions doing business in this state to establish a Financial Institution Record Match system (FIRM) using automated data exchanges to the maximum extent feasible. The provision would require FTB to promulgate any rules or regulations necessary to implement this provision, including following:

- A structure by which financial institutions or their designated data processing agent shall receive from FTB the file or files of delinquent debtors that the institution will match with its own list of accountholder to identify delinquent tax debtor accountholders at that institution.
- An option by which financial institutions without the technical ability to process the data exchange, or without the ability to employ a third party data processor to process the data exchange to forward to FTB a list of all account holders and their Social Security Numbers, or other taxpayer identification numbers so the FTB can match that list with file or files of delinquent tax debtors.
- Authority for the FTB to exempt a financial institution from the requirements of this provision if the FTB determines that the financial institution's participation would not generate sufficient revenue to be cost effective for the department.
- Authority for the FTB to suspend the requirements of this section temporarily for a financial institution if a financial institution provides FTB with a written notice from its supervisory banking authority that it is determined to be undercapitalized, significantly undercapitalized, or critically undercapitalized, as defined. Any notice provided to FTB for this purpose is subject to the same confidentially restrictions that exist for taxpayer or tax return information obtained by FTB.

This provision would provide that any use of the information obtained under this provision for any purpose other than the collection of delinquent franchise or income tax or other debts referred to FTB for collection would be a violation of existing disclosure restrictions. The provision contains express authority for FTB to provide confidential taxpayer data to the financial institutions for purposes of the tax data match.

On a quarterly basis, this provision would require financial institutions to provide FTB the name, record address and other addresses, social security number or other taxpayer identification number, and identifying information for each delinquent tax debtor as identified by FTB who maintains an account at the financial institution as defined. Financial institutions may not disclose to the accountholder, depositor, co-accountholder, or co-depositor that their identifying information has been received for furnished to the FTB, unless required to do so by law.

This provision would state that a financial institution would not incur liability or obligation for any of the following:

- Furnishing information to FTB as required by this provision,
- Failing to disclose to a depositor or accountholder that their personal identifying information was included in the data exchange with FTB, or
- Any other action taken in good faith to comply with the requirements of this provision.

The provision authorizes FTB to institute civil proceedings to enforce the provisions of this provision.

The provision would include that if a financial institution willfully fails to comply with the requirements of the rules promulgated by FTB, unless that failure is due to reasonable cause satisfactory to FTB, the financial institution shall be subject to a penalty upon notice and demand in the amount of $50 for each debtor's record not provided up to a maximum of $100,000 in any calendar year.

The provision would include the following definitions for the terms used:

(1) "Account" means any demand deposit account, share or share draft account, checking or negotiable withdrawal order account, savings account, time deposit account, or money market mutual fund account, regardless of whether the account bears interest.

(2) "Financial institution" means:

- A depository institution, as defined in Section 1813(c) of Title 12 of the United States Code.
- An institution-affiliated party, as defined in Section 1813(u) of Title 12 of the United States Code.
- Any federal credit union or state credit union, as defined in Section 1752 of Title 12 of the United States Code, including an institution-affiliated party of a credit union, as defined in Section 1786(r) of Title 12 of the United States Code.
- Any benefit association, insurance company, safe deposit company, money-market fund, or similar entity authorized to do business in this state.

(3) "Delinquent tax debtor" means any person liable for any income or franchise tax or other debt referred to the FTB for collection as imposed under Part 5 (commencing with Section 10878), Part 10 (commencing with Section 17001), Part 10.2 (commencing with Section 19280), or Part 11 (commencing with Section 23001), including tax, penalties, interest, and fees, where the tax or debt, including the amount, if any, referred to the FTB for collection remains unpaid after 30 days from demand for payment by the FTB, and the person is not making current timely installment payments on the liability under an agreement.

The provision would include reimbursement of one time start up costs in an amount up to $2,500 for each financial institution, and would provide for reimbursement for the quarterly data matches conducted in an amount up to $250 per quarter per financial institution.

The provision would limit the initial size of the FTB data match file sent to financial institutions to no more than 600,000 records and would allow for an incremental increase each quarter of no more than an additional 600,000 records until the full universe of tax debtors is included in the data file.

The provision would be specifically operative 120 days after the effective date of the bill enacting this provision. In addition, the first data exchange for purposes of matching tax debtor records to financial institution account holder records would occur no earlier than April 1, 2012.

IMPLEMENTATION CONSIDERATIONS

FTB would utilize existing systems and functionality to implement this new process. Implementing this provision would have a significant impact on the department, as described below under Fiscal Impact. Due to the changes required, the department anticipates it would be able to initiate levies within 15 months of receiving funding through manual efforts.

PROGRAM BACKGROUND

FTB uses information return data primarily to identify non-filers and collect delinquent income taxes. In the non-filer program, information returns are used in FTB's Integrated Non-filer Compliance (INC) system to identify taxpayers that have sufficient income to require them to file a return but have failed to do so. Under the INC system, more than 220 million records received from employers, financial institutions, the Internal Revenue Service (IRS), and other sources are sorted and matched against tax returns filed. Taxpayers with California income for whom FTB has no record of an income tax return being filed are sent a letter requesting the past due tax return be filed. If a return is not filed as required, the taxpayer's net income is estimated from the available information, and a proposed deficiency assessment is issued.

> FTB uses information returns to collect delinquent income taxes by associating the reported interest, dividend, or miscellaneous payments to the taxpayer with outstanding tax liabilities and issuing a levy to seize the assets of the taxpayer in the hands of a third party. In fiscal year 2009/2010, FTB issued approximately 230,000 financial institution levies and collected approximately $67 million using this process. Information returns do not identify the non-interest bearing assets that may be held at a financial institution and due to the reporting cycle, those returns do not generally provide current information.

In addition to the non-filer and collection programs, FTB has an audit staff designed to encourage compliance with the income tax laws. For this purpose, computer programs search state and federal income records to detect leads as to discrepancies between income items that were reported and should have been reported on income tax returns. Based on the computerized searches of these records, one of many audit-type activities may be initiated, ranging from clerical inquiries, computer-generated inquiries, manual desk audits, or field audits to a combination of computer and manual audits.

Despite these FTB programs, failure to report income still exists. One reality that contributes to failure to report income is the ability of the taxpayer to escape detection. For example, a payer may fail to report a disbursement and the payee may fail to report the income. In the event that the payer and payee have a personal relationship, the likelihood of accurate information return reporting is decreased. Likewise, accurate information return reporting is decreased if an individual is aware of the absence of an income and/or expense paper trail.

Under the FIDM program, which is operated by the FTB on behalf of the California Department of Child Support Services, financial institutions have two methods of transmitting data to comply with the requirements of the program. Method 1 allows financial institutions to send their complete file of financial institution accounts on a quarterly basis to be matched by FTB against child support debtor records. Method 2 requires the FTB to send a file of child support debtors to the financial institution or their third party data processor to match with account holders. A file of matched records is returned to the FTB. Generally, the method chosen by each financial institution depends on the financial institution's data processing capabilities.

LEGISLATIVE HISTORY

ABX8 8 (Committee on Budget, 2009/2010) and SBX8 8 (Committee on Budget and Fiscal Review, 2009/2010) both contained provisions similar to this provision. Neither bill passed the Legislature before the close of the eighth extraordinary session.

ABX3 19 (Evans, 2009/2010) and SBX 3 17 (Ducheny, 2009/2010) both contained provisions similar to this provision. ABX3 19 was sent to enrollment but was withdrawn from enrollment without action by the Governor. SBX3 17 was vetoed by Governor Schwarzenegger on June 30, 2009, stating the bill failed solve the entire budget deficit.

SB 402 (Wolk, 2009/2010) contained provisions to implement FIRM that were similar to the provisions in this bill. The provisions to implement FIRM were amended out of SB 402.

OTHER STATES' INFORMATION

Laws in *Indiana, Kentucky, Maine, Maryland*, *Massachusetts, Minnesota, New York, New Jersey* and North Carolina provide the revenue departments of those states authority to use a financial institution record match process for the collection of delinquent income taxes.

In *Indiana*, financial institutions are reimbursed at least $5 for every warrant issued from the data obtained through the match process.

In *Kentucky*, the financial institutions that provide debtor records may charge a fee against an account levied by the Department of Revenue under the match process. The fee may not exceed $20.

Maine statutes provide for reimbursement to financial institutions of a reasonable amount not exceeding the actual costs incurred by the financial institution to conduct the matches.

Maryland financial institutions are reimbursed the actual costs incurred.

It does not appear that the laws in *Massachusetts* or *New Jersey* permit reimbursement to financial institutions that provide customer records.

Minnesota statutes provide for reimbursement for costs incurred in the data match to financial institutions up to $150 per quarter.

New York's financial Institution record match program does not provide for any reimbursement to the financial institutions to conduct a data match.

North Carolina statutes provide for reimbursement to financial institutions of a reasonable amount not exceeding the actual costs incurred by the financial institution to conduct the matches.

FISCAL IMPACT

Because FIRM was not adopted in the 2008/2009 fiscal year, the department directed information technology resources towards other priority projects. Those resources would have been used to modify the department's computer systems to automate the use of the data matches obtained by FIRM. Because those resources are no longer available, the department would implement FIRM by utilizing a third party vendor to assist in the data matching with the financial institutions. Once the matched data is received, FTB will use additional collection staff to add the new financial data obtained manually into the collection system and to issue orders to withhold to financial institutions subsequently. This change results in lower project costs, but also limits the ongoing revenue previously anticipated from FIRM. The department estimates that revenue attributable to the FIRM data would start within 15 months of receiving funding to secure procurement of a third party vendor and develop secure transmission protocols with the financial institutions. The department would automate the use of the data matches obtained by FIRM eventually and would utilize the normal budget change proposal process to obtain funding.

The fiscal costs are estimated to be as follows:

	FY 2010/11	FY 2011/12	FY 2012/13	FY 2013/14	Total
Total Project Costs	**$299,377**	**$711,151**	**$337,191**	**$337,191**	**$1,684,910**
Total Financial Institution Reimbursement Costs	$0	$495,000	$2,155,000	$800,000	**$3,450,000**
Other Program Costs	$0	$45,750	$2,643,193	$2,481,586	**$5,170,529**
Total Program Costs	$0	**$540,750**	**$4,798,193**	**$3,281,586**	**$8,620,529**
Total Project + Program Cost	**$299,377**	**$1,251,901**	**$5,135,384**	**$3,618,777**	**$10,305,439**

ECONOMIC IMPACT

Revenue Estimate

Estimated Revenue Impact of FIRM Provision Enactment Assumed by May 1, 2011 ($ in Millions)		
2011/12	**2012/13**	**2013/14**
$37	**$30**	**$32**

SUPPORT/OPPOSITION

Support: None provided.

Opposition: None provided.

Appointments

None.

VOTES

Concurrence	03/17/11	Y: 23	N: 17
Assembly Floor	03/17/11	Y: 52	N: 25
Senate Floor	02/14/11	Y: 22	N: 2

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